

17 January 1985

PRIME MINISTER

THE DOLLAR/STERLING EXCHANGE RATE

1. Those who predicted a fall in the dollar forgot the workings of the US banking system. Because the banking system was so illiquid, it was not going to lend overseas, and it needed to bid up rates to attract deposits from across the world. We have therefore lived through a period of intensely high real interest rates, and the US economy has been shielded from the worst effect through the tax breaks for domestic borrowers.

2. It is likely that at some point the dollar will come down. Confidence never lasts for ever. It is most likely to start coming down when everybody believes it will no longer do so: at that point, everyone will be long of dollars and short of other currencies, and there will be nobody else left to buy more dollars to drive it higher. Markets often turn downwards once everybody is bullish.

3. Yes, the world's money markets do operate as a single pool, communicating with each other, with currencies trading round the clock from centre to centre. But

there is no simple contrast between "financial investment" and "industrial investment". Money placed in banks gets lent on to industrial or service sector activities.

4. Returns last year on United Kingdom equities and United States equities for the UK holder were similar - a total return of a little over 30 per cent. If the UK investor had invested in Tokyo Stock Exchange yen securities, he would have made an even higher return. The bulk of the return in the States came from the rise of the dollar: the Stock Market itself was very unexciting. People have been surprised by the amount of money they have made by holding dollars, and this is an important psychological factor.

5. Information is important. But in markets, animal spirits have always been crucial, as Keynes recognised. You cannot quantify animal spirits, but you can quantify the trends and matters that underlie them.

Conclusion

There are good economic reasons why the dollar has remained strong, as we have explained in notes over the last year or so. They relate to the banking system, interest rates, and to the flows of money around the world. It still remains impossible to predict accurately when the strength of the

dollar will come to an end - as investors, speculators and
advisers who have tried to do so have found over the last 2
or 3 years. I am not normally reluctant to make a forecast,
but on this occasion all I would say is that the dollar
hasn't started to weaken yet, but we may be able to
recognise a change in trend when it does.



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